Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Best Practices In Light Of SEC Whistleblower Trends

Law360, New York (September 30, 2013, 3:58 PM ET) -- In response to the perceived failures of regulatory agencies to discover improprieties in the securities and commodities markets, the U.S. Securities and Exchange Commission supplemented the Dodd-Frank Act in August 2011 with new rules designed to utilize the whistleblower as an enforcement tool. Codified in Section 922, these new rules provide protection from retaliation and reward employees who report "original information" about a violation of the federal securities with between 10 percent and 30 percent of any judgment in a successful enforcement action — either judicial or administrative — exceeding $1 million. The Office of the Whistleblower was established to administer this new whistleblower program.

The practical importance of the new whistleblower program is clear, as it is designed to increase whistleblower activity, and the immense monetary incentives already have generated an influx of tips. In its first year, the program received over 3,000 tips, complaints, and referrals, which is approximately 17 percent more than 2011.[1] But the actual significance of the program remains largely untested. The number of enforcement actions brought by the SEC remained nearly equivalent to the prior year — 734 in 2012 versus 735 in 2011.[2] And although the SEC identified 143 of these 2012 actions as potentially eligible for a whistleblower award[3], awards have only been granted in two cases to four total individuals.[4] Still, the program's potential to dramatically increase enforcement actions remains cause for great concern for companies and corporate compliance officers.

The program contains a strong incentive for employees to report misconduct or infractions directly to the SEC and thereby bypass internal corporate compliance programs. To be fair, the rules attempt to encourage compliance with internal compliance regimes, but they do not require internal reporting. For example, if an employee reports original information internally, and the company passes that information to the SEC, the whistleblower will get credit for any additional information generated by the company in its investigation. Second, a whistleblower is permitted 120 days from the time of his or her first internal reporting to report directly to the SEC and still be treated as if he or she had reported to the SEC on an earlier date. And third, a whistleblower's voluntary participation in an internal compliance program "is a factor that can increase the amount of an award."[5] In any event, there are procedures that companies can implement that may have the effect of encouraging employees to report misconduct internally, which will both benefit the company from a litigation standpoint and allow for the remediation of issues before the SEC is involved. Such measures include the following:

1. Revise the rules. Companies should refine their codes of conduct and compliance policies to formally stress the importance of compliance with securities laws and to emphasize that employees are required to aid in maintaining compliance both by complying with the standards themselves and also by reporting those who run afoul of the laws. As an additional matter, these codes and policies should be complied with at all levels, especially at the board level, so as to set a good example for the remainder of the employee base and to emphasize a culture of compliance.

2. Educate employees. To give the newly revised codes and policies the maximum effect, they should be drafted in easily understandable language and should be thoroughly explained — along with the guiding principles and legal requirements behind them — to employees at all levels through mandatory training. Employees should also be familiarized with the steps and timeline of the reporting process, discussed below, to foster an understanding of and confidence in the system. It may also be effective to confront employees with hypothetical compliance situations typically encountered by the company to explain the possible consequences of unreported misconduct and also to offer advice on how to handle the situations. And after training is complete, companies may consider obtaining signed acknowledgements from each employee and board member which state that he or she understands the codes and policies and will adhere to them. This is a procedure that should be repeated annually, and it could serve as a tool to re-emphasize the importance of compliance and it may also provide companies with a proactive opportunity to follow up on negative or nonresponses.

Further educational information regarding compliance issues should be provided on a regular basis and can be disseminated through a variety of means, including annual presentations or weekly newsletters or email alerts. Frequent correspondence will keep employees appraised of the importance of compliance, and, especially if some of these materials come from the CEO or others in leadership positions, will reinforce the culture of compliance. These materials could also include examples of benefits that have resulted from the internal reporting process, as a means to show employees that their complaints are taken seriously.

3. Implement a robust internal reporting system. An essential element of requiring that employees prioritize compliance is implementing an efficient and effective internal reporting system with adequate staff and resources to investigate complaints of wrongdoing. Often a combination of complaint-intake methods can help promote internal reporting. For example, some employees may prefer to report compliance issues to their direct supervisors, who should be trained on recognizing potential whistleblower complaints, identifying to whom complaints should be reported, and how to appropriately respond to any complaints received. Other employees may prefer an anonymous system for submitting reports, such as a secure telephone tip line or an online submission system, potentially managed by a third party.

After receiving a complaint, companies should ensure that they have procedures in place to effect a swift response by both investigating the tip and remedying any discovered wrongdoing within about four months, if at all possible, in light of the whistleblower program's 120-day grace period for the reporting employee to file a complaint with the SEC after reporting internally. A quick response also will increase the probability that employees will be satisfied with how their reports are treated internally, which should make them less likely to seek outside assistance from the SEC. Providing reporting employees with proper follow-up documentation is also an important step. Companies should consider providing written documentation to the complaining employee acknowledging receipt of the complaint and explaining the procedures and timeline for investigating the complaint.

Other determinations that must be made in order for an internal reporting system to operate efficiently include deciding which individuals will be responsible for conducting the investigation and interviews, how the investigation findings will be documented, and when complaints will be transferred to outside counsel. It is advisable to engage outside counsel experienced in SEC investigations to develop an appropriate reporting system.

Additionally, at the outset of any investigation, whether internal or by the SEC, all arguably relevant contemporaneous documents must be preserved. The first step in this process is to suspend any normal retention policies that are in place for more stringent policies that do not delete items over a certain age. In addition, the affected employees should be adequately instructed to preserve all relevant documents. To achieve these ends, companies should consider implementing more expansive backup systems, imaging employee hard drives, restricting access to certain computers or data, and carefully monitoring attempts to delete or destroy documents. To further the effectiveness of any document-retention policy, supervisory employees should be sufficiently educated about the importance of policy and how to initiate prompt document holds on the first signs of an investigation.

4. Prohibit retaliation. Companies should take extra care to make sure that retaliation against reporting employees is strictly and explicitly prohibited, first by including relevant language in the codes of conduct and compliance policies and second by educating employees on the prohibited practices. In addition, all employees should be notified, in writing, that anyone who retaliates, harasses, or discriminates against another employee for raising concerns will be subject to disciplinary action, up to and including termination. Following an internal report of misconduct and investigation, management should periodically follow up with the reporting employee regarding any retaliation concerns.[6]

5. Change the way terminations and layoffs are conducted. Companies should ensure that their form release agreements, exit interview forms, and arbitration agreements do not require the departing employee to release all claims he or she has against the company. Rule 21F-17(a), promulgated under the authority of Dodd Frank Act Section 922, explicitly prohibits companies from taking actions "to impede an individual from communicating directly with the commission staff about a possible securities law violation." This rule makes clear that language in severance agreements, both explicit and vague, that prohibits employees from going to the SEC with allegations of infractions and improprieties is an improper method for restraining potential whistleblowers.

Even within these restrictions, companies should also take care to conduct thorough exit interviews and to ask specifically about any compliance issues or concerns the departing employee may have before that employee leaves the company. If a company encounters an employee with a claim that it cannot prevent from going to the SEC, it should engage counsel, initiate its internal investigation, and institute a document-retention hold procedure.

6. Consider creating an internal incentive structure for successfully investigated complaints. Creating an incentive structure could provide a useful counterpoint to the SEC's monetary incentives by encouraging employees to be proactive in raising concerns through the employee review process and fully utilizing the internal reporting procedure. And although companies most likely are not in the position to offer the incentives in the same amount as the SEC, this potential reward could have the positive side effect of fostering a culture of compliance and emphasizing a desire to be in compliance with the securities laws.

The goal of these initiatives is to foster an environment where ethics and compliance are of paramount importance. Thus, identifying areas of concern early will allow for swift corrective action, which will result in fewer complaints being filed. And, when a complaint is filed, the company will be in a position to demonstrate its robust compliance programs to the SEC, which when coupled with a general spirit of cooperation, could favorably result in the SEC allowing the company to conduct an internal investigation and to report back to the agency.

—By Dana S. Douglas and Kathleen M. Przywara, Mayer Brown LLP

Dana Douglas is a partner in Mayer Brown's Chicago office. Kathleen Przywara is an associate in the firm's Chicago office.

[1] U.S. Securities and Exchange Commission, Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2012 (November 2012).

[2] Press Release 2012-227, SEC's Enforcement Program Continues to Show Strong Results in Safeguarding Investors and Markets (Nov. 14, 2012), available at http://www.sec.gov/news/press/2012/2012-227.htm.

[3] Press Release 2012-229, SEC Receives More Than 3,000 Whistleblower Tips in FY2012 (Nov. 15, 2012), available at http://www.sec.gov/news/press/2012/2012-229.htm.

[4] The first award was granted in August 2012 in the amount of $50,000. Press Release 2012-162, SEC Issues First Whistleblower Program Award (Aug. 21, 2012), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171483972. The second awards were granted in June 2013 to three individuals who brought forth information that supported the SEC's enforcement action against a sham hedge fund and its CEO. Each whistleblower was awarded five percent of the total judgment, totaling a 15 percent award. The SEC recently announced that the award will amount to about $125,000 to be split among the three individuals. Andrew C. Hicks and Locust Offshore Management, LLC, Release No. 69749 (June 12, 2013), available at http://www.sec.gov/rules/other/2013/34-69749.pdf; Press Release 2013-169, SEC Awards Three Whistleblowers Who Helped Stop Sham Hedge Fund (Aug. 30, 2013), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539796657.

[5] Release No. 34-64545, Implementation of the Whistleblower Provisions of Section 21F of the Securities and Exchange Act of 1934 (August 12, 2011) at 5, available at http://www.sec.gov/rules/final/2011/34-64545.pdf.

[6] Despite the Fifth Circuit's recent decision in Asadi v. GE Energy (USA) LLC, No. 12-20522 (July 17, 2013), which held that Dodd-Frank Act does not protect employees who report wrongdoing only internally, companies should continue to publicize that retaliation will not be tolerated, so as to not undermine the internal reporting process.